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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Uniform Issue List: 414.09-00

Contact Person:

Telephone Number:

In Reference to:
T:EP:RA:T1

Date:
JUN 6 2000

Attn:

Legend:

Employer A =

State B =

Plan X =

Dear :

This is in response to a ruling request dated November 15, 1999, concerning the pick up of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

Employer A, a political subdivision of State B, sponsors Plan X, a governmental plan under Code section 414(d), for the benefit of its employees. Plan X requires mandatory employee contributions and is qualified under Code section 401(a).

Upon retirement, members of Plan X are eligible to receive benefits. The monthly benefit is based upon a formula which takes into account an employee's age, his length of service, and the average of his highest three year's salary. In general, a member's length of service determines his "service credit". The longer a person is employed by the State or by one or more local government units, the more "service credit" he or she accumulates. If an employee leaves the employ of State B or any of its subdivisions prior to retirement, he or she may elect to withdraw or cash out the full amount of the employee's prior contributions, thereby foregoing the receipt of any Plan X benefits and thereby canceling his service credit in the system. It sometimes happens that former Plan X members who have cashed out their prior contributions

are re-hired. Under the Revised Code of State B, such employees are entitled to restore their membership in and repurchase their service credit for their prior service in the system by redepositing in the employees' savings fund the amount withdrawn, with interest on such amount at a rate to be determined by the Retirement Board of Plan X.

Effective February 1, 1997, State B amended its administrative code to permit counties to establish payroll deduction/reduction plans for the purpose of enabling their employees to either (1) repurchase service credit with after tax dollars, either in a lump sum purchase, or by means of an after-tax payroll deduction plan, or (2) repurchase service credit with pre-tax dollars by payroll reduction by means of a pick up plan.

By resolution dated November 2, 1999, Employer A, in compliance with the provisions of state law, adopted a resolution establishing such a pick up plan. Under the resolution, employees may repurchase service credit on a pre-tax basis, and Employer A shall withhold the required service credit reduction from the gross pay of each person who elects to do so. Under the resolution, Employer A shall pick up (assume and pay) such reduction and remit the picked up amounts to Plan X. A person electing this pick up will not have the option of choosing to receive the picked-up amounts directly instead of having them paid by the employer to the pension plan. Once a person elects to participate in the pick up, he or she will not be permitted to increase, decrease, or terminate the amount of the pick up reduction.

Before an employee will be permitted to repurchase service credit time by payroll reduction, he or she will be required to make an irrevocable election to purchase a specified period of service, and to have a specified bi-weekly sum withheld from his or her wages. This election must be made before the wages from which the withholdings will be made are earned. The member must sign a payroll reduction authorization form for the credited service to be repurchased.

Based on the foregoing facts and representations, you have requested the following rulings:

1) That the payroll reduction (pre-tax) amounts made pursuant to State B's revised code provisions for the purpose of repurchasing service credit time within Plan X are deemed to be employer pick up contributions under Code section 414(h), and thus are not taxable to the employee for federal income tax purposes when they are earned and paid over to Plan X, but are rather taxed to the employee only when such funds are distributed by Plan X to the employee.

2) That pursuant to Code section 3121(b)(7), amounts deducted from an employees' wages pursuant to State B revised Code Section 145.294 and State B Administrative Code Section 145-9-08 for the purpose of repurchasing service credit time with Plan X (which are deemed to be employer pick ups under Code section 414(h)(2)), are excepted from the definition of wages paid with respect to employment for purposes of the Old Age Survivors Disability Tax (OASDI) imposed by Code section 3101(a) and 3111(a).

3) That with respect to employees who are otherwise subject to the Medicare tax, i.e., employees who were hired after March 31, 1986, the amounts deducted from employees' wages pursuant to State B revised Code Section 145.294 and State B Administrative Code Section 145-9-08 for the purpose of repurchasing service credit time with Plan X are not wages paid with respect to employment for purposes of the Medicare or hospital insurance tax imposed by Code section 3101(b) and 3111(b), and thus Employer A is not required to withhold Medicare tax from such amounts and is likewise not required to match such amounts.

Code section 414(h)(2) provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in Code section 401(a), established by a state government or a political subdivision thereof, or any agency or instrumentality of any one of the foregoing, and are picked up by the employing unit.

The federal income tax treatment to be accorded contributions which are picked up by the employer within the meaning of Code section 414(h)(2) is specified in Revenue Ruling 77-462, 1977-2 C.B. 358. In that revenue ruling, the employer school district agreed to assume and pay the amounts employees were required by state law to contribute to a state pension plan. Rev. Rul. 77-462 concluded that the school district's picked up contributions to the plan are excluded from the employees' gross income until such time as they are distributed to the employees. The revenue ruling held further that under the provisions of Code section 3401(a)(12)(A), the school district's contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages; therefore, no withholding is required from the employees' salaries with respect to such picked up contributions.

The issue of whether contributions have been picked up by an employer within the meaning of Code section 414(h)(2) is addressed in Revenue Ruling 81-35, 1981-1 C.B. 255 and Revenue Ruling 81-36, 1981-1 C.B. 255. These revenue rulings established that the following two criteria must be met: (1) the employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and (2) the employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan. Furthermore, it is immaterial, for purposes of the applicability of Code section 414(h)(2), whether an employer picks up contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

In Revenue Ruling 87-10, 1987-1 C.B. 136, the Internal Revenue Service considered whether contributions designated as employee contributions to a governmental plan are excludable from the gross income of the employee. The Service concluded that to satisfy the criteria set forth in Revenue Rulings 81-35 and 81-36 with respect to particular contributions, the required specification of designated employee contributions must be completed before the period to which such contributions relate.

Under Employer A's resolution and payroll reduction authorization agreement, an employee may purchase additional service credit under Plan X through salary reduction contributions made pursuant to a binding, irrevocable payroll reduction agreement. These contributions will be picked up and paid by Employer A, although they are designated as employee contributions. Employees will not have the option to receive the amounts under the agreement directly instead of having them contributed to Plan X.

Accordingly, with respect to ruling request (1), we conclude that the contributions for the repurchase of credited service picked up by Employer A (as described above) satisfy the requirements of Code section 414(h)(2). Therefore, these amounts are treated as employer contributions and are not includable in employees' gross income for the taxable year in which such amounts are earned or contributed to Plan X.

Because we have determined that the picked up amounts are to be treated as employer contributions, they are excepted from wages as defined in Code section 3401(a)(12)(A) for Federal income tax withholding purposes. Therefore, no withholding of Federal income tax is required from employees' salaries with respect to such picked up amounts.

The effective date for the commencement of the proposed pick up cannot be any earlier than the later of the date the November 2, 1999 resolution is signed or put into effect.

Concerning ruling request (2), taxes under the Federal Insurance Contributions Act (FICA) consist of the old-age, survivors and disability insurance (OASDI) taxes imposed under sections 3101(a) and 3111(a) of the Code and the hospital insurance (Medicare) taxes imposed under Code sections 3101(b) and 3111(b). FICA taxes are computed as a percentage of "wages" paid by the employer. Under section 3102, the employer must withhold the employee's portion of FICA taxes from the employee's wages.

Section 3121(a) defines "wages" for FICA purposes as all remuneration for employment. Section 3121(v)(1)(B) of the Code provides that other than the FICA wage base limitation, nothing in section 3121(a) excludes from the term "wages" any amount picked up as an employer contribution under section 414(h) if the pickup is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise). For these purposes, the term "salary reduction agreement" includes any salary reduction arrangement, regardless of whether there is approval or choice of participation by individual employees or whether such approval or choice is mandated by state statute. Public Employees' Retirement Board v. Shalala, 153 F.3d 1160 (10th Cir. 1998); H.R. Conf. Rep. No. 861, 98th Cong. 2d Sess. 1415 (1984).

Section 3121(b) defines "employment" as "any service, of whatever nature, performed . . . by an employee for the person employing him" with certain specified exceptions. Therefore, if service does not constitute employment under section 3121(b), remuneration for that service does not constitute wages under section 3121(a), regardless of section 3121(v)(1)(B).

With respect to the OASDI portion of FICA taxes, section 3121(b)(7)(F) provides that with the exception of certain services not relevant here, the term "employment" shall not include service in the employ of a State or of any of its political subdivisions[1], but "employment" shall include service in the employ of a State or its political subdivisions by an individual who is not "a member of a retirement system of such State." The regulations specify two requirements that must be met to qualify for this exception from "employment" for state employees covered by a state retirement system.

First, the retirement benefit provided by the state's retirement system must be comparable to the benefit provided under the Old-Age portion of the Old Age, Survivor and Disability Insurance program of Social Security. Treas. Reg. § 31.3121(b)(7)-2(e)(2). Whether this requirement is met is determined on an individual-by-individual basis, so that a state's plan may be a "retirement system" within the meaning of the section 3121(b)(7)(F) with respect to some employees, but not with respect to others, because of the level of benefit accrued by the individuals. Second, the regulations provide that the exception from "employment" under section 3121(b)(7)(F) does not apply unless, at the time the services were performed, the employee was a "qualified participant" of the state's retirement system. Treas. Reg. § 31.3121(b)(7)-2(c)(1). For example, if an employee has not satisfied all conditions (other than vesting) for having an accrued benefit, such employee will not be considered a "qualified participant" of the plan. Treas. Reg. § 31.3121(b)(7)-2(d)(1)(i).

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[1]Under section 3121(b)(7)(E), service is included in employment if it is covered by an agreement between the State and the Social Security Administration under section 218 of the Social Security Act. We have been informed that the services of employees of Employer A are not covered under such an agreement.

Based solely on the facts submitted, Employer A is a political subdivision of State B. To the extent Employer A's employees (1) are members of State B's retirement system within the meaning of section 3121(b)(7)(F) and the regulations thereunder and (2) qualify for benefits comparable to the benefits provided under the Old-Age portion of the Old Age, Survivor and Disability Insurance program of Social Security, we rule that the amounts picked up by Employer A with respect to such employees are not subject to the OASDI portion of FICA taxes and Employer A has no obligation to withhold the OASDI portion of FICA taxes, or to pay the employer's portion of OASDI taxes, on such pick-up amounts. Employer A must withhold and pay the OASDI portion of FICA taxes with respect to pick-up amounts for employees whose service is not excepted from employment under section 3121(b)(7)(F).

No opinion is expressed as to whether every employee of Employer A meets the requirements of section 3121(b)(7)(F).

Concerning ruling request (3), hospital insurance or Medicare taxes are imposed under sections 3101(b) and 3111(b) as a percentage of "wages" paid by an employer and received by the employee with respect to "employment." Under section 3121(v)(1)(B), pick-up amounts are generally wages for FICA purposes.

Although the language of section 3121(b)(7)(F), discussed above, might appear to apply to the Medicare portion of FICA taxes, Code section 3121(u)(2) provides generally that the provisions of section 3121(b)(7) should not be applied to the determination of taxes that are imposed by Internal Revenue Code sections 3101(b) and 3111(b). Section 3121(u)(2)(C) provides a "continuing employment" exception regarding Medicare taxes with respect to state or local government employees who have been continually employed by the same employer since March 31, 1986. If an employee of a state or its political subdivision does not qualify for the continuous employment exception, however, the employer is liable to withhold the employee portion of, and pay the employer portion of, Medicare taxes with respect to such employee's wages.

Based solely on the facts submitted, the employer pick-up amounts are made pursuant to a salary reduction agreement. To the extent the pick-up amounts are made with respect to employees who do not qualify for the continuous employment exception under section 3121(u)(2)(C), such amounts are "wages" paid by Employer A pursuant to "employment" so that Employer A is required to withhold the employee's portion of, and pay the employer's portion of, Medicare taxes on the pick-up amounts with respect to such employees.

These rulings are based on the assumption that Plan X will be qualified under Code section 401(a) at the time of the proposed contributions.

These rulings are directed only to the taxpayer that requested it. Code section 6110(k) provides that it may not be used or cited by others as precedent.

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A copy of this ruling has been sent to your authorized representative pursuant to a power of attorney on file in this office.

Sincerely yours,

John Swieca

Employee Plans Technical Group 1
Tax Exempt and Government
Entities Division

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: